The Growlery - The Merger Game Starts with Deception

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> You've got perhaps ten men guiding the future of corporate America.
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> —Ivan Boesky, Well-known merger investment specialist

Mergers, acquisitions, and hostile take-overs are hot stuff. There are now some 3,000 a year taking place compared to 1,500 in 1980. The dollars involved were less than $20 billion a year in 1974, more than $40 billion a year in 1980, and approximately $173 billion in 1985. A more than fourfold increase in five years' time indicates that a major restructuring of corporations is now going on—and the end is nowhere in sight. Ivan Boesky, one of the best-known take-over artists, has recently decided to increase his leveraging account from $200 million to $1 billion, and anyone can buy into this deal for a cool million. With this money, he will stand as a threat to many boards of directors and managements, and he will undoubtedly wreak havoc on workers threatened with unemployment; stockholders who want to stay with the corporate entity as is; the general public as it is increasingly faced with monopolistic or oligopolistic business practices; and the economy, which is already afloat in the junk bonds which threaten its growth and vitality. There are also taxation questions raised by such activity, and there is little question that the capital resources used up in such games has a deleterious effect upon research and development. There are at least indirect effects upon such global concerns as international trade and Third World development. And most importantly, the entrepreneurial myths in American capitalism tend to be exploded when the various tax incentives found in our laws and the much-trumpeted abilities to create product innovations and new jobs are lost in these money-shuffling and debt-creating machinations.

This combination process begins with deception. The Williams Act of 1968 requires disclosure of ownership of significant blocks of securities. If a take-over artist such as Carl Icahn or Victor Posner acquires as much as 5 percent interest in a company, this must be disclosed. When this information is provided to the Securities and Exchange Commission, it must be accompanied by an explanation. This explanation—sometimes reported on in

the press—is invariably a statement that the acquirer has bought into the company for investment purposes only. Few knowledgeable observers believe this, particularly when the “investor” is a well-known take-over artist.

The “insider” issue

Before such an item ever appears in the financial press, however, informed investors will have bought into the stock; for despite the rules against “insider” trading or disclosure, the tips will be out on Wall Street. This is shown by the almost invariable uptick in the price which occurs *before* the take-over artist’s announcement is made. When the stock really begins to take off as a result of the buy-out expectations and the premium price that is anticipated, these “insiders” will take their profits. The biggest “insider” of all, of course, is the investor who has reported his 5 percent or greater interest; he or she can be expected to profit merely from buying into the company and staking out an interest. Since the stock goes up on this information in nearly all circumstances, the acquirer can determine his or her own profit in a way that is analogous to shooting fish in a barrel.

At this very outset of the takeover or merger process, then, there are ethical and legal questions to grapple with: whether deception has occurred; whether “insider” money-making is involved caused by the announcement; and whether the self-directed “insider” has an advantage in raising the price of securities merely by indicating an interest in them.

Antitrust violations and nonenforcement

A second set of problems presented almost immediately by buy-out activity is found in antitrust considerations. In particular, this is the case in proposals for mergers or takeovers which are “horizontal”; that is, those which involve the combining of former competitors. There is still a major problem, however, when a “vertical” union is proposed—one in which the firms involved are not direct competitors. These arrangements can often be just as bad for the economy and for the general public as the “horizontal” deals. Centralization seems to produce no particular efficiencies; indeed, the economic evidence appears to be to the contrary. (It is interesting to reflect upon the Reagan administration’s attitudes about bureaucracy that seem to support an unlikely thesis that while government, in the nondefense sector, gains efficiency as it grows smaller, corporations gain efficiency as they grow larger.) In order to determine whether monopolistic or oligopolistic conditions are threatened by a proposed merger, the present administration has devised an “HHI Index” (named for its creators, Herfindahl and Hirschman) which, though it is a lax and watered-down guide to measuring monopoly or oligopoly, has the virtue of relying upon a simple formula. Unfortunately, the formula is observed in the breach as much as in application, so that, by and large, the administration has all but abandoned antitrust enforcement.

Qualms generated by buy-out activity

Receipt of the offer of purchase causes no particular worries in the board room or in top management if the offer is “friendly”; that is, if it is presumed that the buy-out forces do not plan to replace them. Employees, of course, may lose out even in a friendly merger. And it should be borne in mind that even a friendly merger is often an unproductive use of capital. The recent General Electric acquisition of RCA Corporation, for example, was regarded by many Wall Street observers as an uninspired use of $12 billion; and this was a cash deal, the kind which presumably does the least harm to the economy.

Unfriendly offers, which are assumed by the target company’s leadership to mean the likely end of their careers with the firm, may be unanticipated and can cause a great deal of consternation. Will the firm continue to exist in some recognizable form or another? In the case of many companies, the answer clearly has been negative. What about existing labor contracts? And what will happen to middle management? Book company managements have been known to be replaced by broadcast people when the latter took over the book firm; it was explained that, after all, broadcast people, like book people, are in communications.

Experience shows that the very top-level people in a firm have nothing worse to fear than a “golden parachute” arrangement of pay and other conditions of severance which will make them rich even if they are no longer powerful.

All kinds of factors can obtain, of course, in a buy-out deal. It may be in the best interests of the top leaders of a firm, and even of its stockholders and employees, to acquiesce; or it may be best to fight. Sometimes it is possible to win by losing—by paying the take-over artist to leave the company alone.

Greenmail

Many offers to take over a company (so-called "tender offers") are made with little or no thought of actually taking it over. The objective in these cases is to threaten the board and management but, after a variety of financial and legal skirmishes, to withdraw—if the company will pay off with "greenmail." Greenmail, technically speaking, is the premium over market value paid by a company to the raider for its own stock in order to obtain withdrawal from a proxy fight (the fight for control of the firm). Let us assume a market value of $40 per share. The stock goes to $52 on the news of the take-over attempt. (Again, the reader is reminded that there is already a great short-term gain on the investment which has occurred only because the take-over artist decided to make it happen.) After considerable public and private maneuvering, let us assume that the take-over investor is prevailed upon (more likely, advised by the legal and financial staff at his disposal) to sell his interest in the company and to give up the thought of taking it over. When this occurs, a contract is drawn up which guarantees that the raider will not try to do this again for a set number of years. In exchange for this agreement, he sells his stock back to the company for a price of, say, $62. (The terms of the agreement outlined in this example are quite typical.) The take-over artist, or "broker," which is his usual title, has been well rewarded for notifying the SEC about buying into the company "for investment purposes" and for carrying out a war of nerves against the firm.

Most hostile take-over attempts result in greenmail; in other words, they are "unsuccessful" and, it is often alleged, are meant to be. The take-over investor would actually have to run the company if he won control, and that is not usually the object of this game. Greenmail amounts can be substantial. Some recent examples are $100 million paid to Sir James Goldsmith by St. Regis Paper; $163.6 million paid to Carl Icahn by Chesebrough-Ponds; $180 million given to Rupert Murdoch by Warner Communications; $325 million paid to Saul Steinberg by Walt Disney Productions; $471.7 million awarded to the famous (or infamous) T. Boone Pickens by Phillips Petroleum; and $178 million turned over to the Bass Brothers by Texaco.

Greenmail payments can substantially weaken a corporation. In the Disney case, for example, the floating of a large amount of debt was necessary to pay

off Steinberg and the company's debt-to-equity ratio was severely affected. This ratio is presently at near-record levels for all of corporate America, and much of the reason is found in these kinds of activities. Some companies sell off assets while others turn to the high-interest instruments known as "junk bonds." Whatever financial strategy is decided upon, the corporation can only come off badly from a take-over battle.

The game for the greenmailer, who is uninhibited by the law, goes on. There are thousands of available targets. Some companies have erected defenses against takeovers, but they are not impenetrable. One of the most pernicious of these defenses is the "poison pill," or the acquisition of debt (often in "junk bonds" form) in order to make the target firm less attractive. Needless to say, companies that involve themselves in this kind of activity weaken their capital structure and may also hurt the economy generally because of the increased floating of questionable instruments of indebtedness.

Leveraged buy-outs

Most mergers, acquisitions, and hostile take-overs are leveraged buy-outs if they succeed. A leveraged buy-out is any acquisition of a company which leaves the acquired operating entity with a greater than traditional debt-to-equity ratio. There are varieties of leveraged buy-outs, to be sure. They can be aimed at asset acquisition or stock acquisition or both. They can be aimed at a division or part of a company such as those found in a conglomerate. And they can be fostered by arrangements involving secured or unsecured financing. The tendency today, in our increasingly loose and ungovernable financial markets, is toward the latter. “Junk bonds” are expected to do their magic.

A host of arrangements are available for a leveraged buy-out, but one particular form deserves special comment. This one, which is increasingly in vogue, involves only a small number of investors, bankers, and company officials who manage to take a company out of the stock market altogether. It “goes private.” This has happened recently in the case of Beatrice, R. H. Macy, and other companies, some of them extremely large, with assets in the billion-dollar range. The primary actors in such a deal are the managements of public companies. These individuals may start out with relatively few shares. In the course of the buy-out, however, they acquire all of the company (with the help of a few select outside investors and a huge amount of debt, much or most of it in the form of “junk bonds”). Some of these deals leave the company with debt-to-assets ratios as high as 80 percent. Often there is conflict of interest set up by this arrangement, because the management, rather than representing the interests of the stockholders as imposed by their fiduciary relationship and responsibilities, may well be imperiling the company’s financial stability. The argument that a discontented stockholder can always sell her or his shares begs the question of the long-term interests of the firm and the economy in general. The process of “going private” is, naturally, the ultimate defense against take-overs or, in the words of one merger lawyer, “the ultimate lock-up.”

“Junk Bonds”

“Junk bonds” have been overwhelmingly important engines of the merger, acquisition, and takeover activity of recent years. The brokerage industry prefers the term “high-yield” bonds, but “junk bonds” is most descriptive of these admittedly shaky debt instruments.

These bonds have been around most of this century, but they have had no great importance in securities markets until about 1980. They are indeed high-yield, which reflects their stature in the world of securities and debt instruments. A further reflection is their rating: neither Moody’s nor Standard and Poor’s, the two bond-ranking services, gives them any rating at all.

They are not AAA, AA, B, C, or any other bond. They get no rating because they apparently deserve none.

The classic use of junk bonds has been to get a company “over the hump”; that is, to give it perhaps one last chance to become profitable again by allowing it to borrow at high rates of interest. The investors who buy such instruments realize that the purchase is risky.

No great threat was posed to the economy as long as junk bonds represented something like 3 or 4 percent of the debt instruments in the market. But today they comprise nearly 20 percent of the debt instruments floating around, and the reason for this is simple enough. They are the preferred vehicles for mergers, acquisitions, hostile takeovers, and all sorts of leveraged buy-outs. Their value, which is dubious, is premised upon the future sale of assets of the target firm. In other words, junk bonds are nothing, in most instances, except a promise to liquidate some of the assets of a company once a take-over attempt has succeeded.

This brings up an important point. Hostile take-overs and many or most leveraged buy-outs have *asset liquidation*—the selling off of company assets—in mind as the way out of the intensely leveraged debt situation they create. Ted Turner, for example, intended to float vast amounts of junk bonds, as many as he could print, in order to take over CBS. His intention, never unclear, was to sell off such company assets as rich local outlets or this or that division. His effort did not succeed for a variety of reasons, including

prudent defenses established by CBS. There is no doubt that a smaller CBS would have been the result of these machinations if they had succeeded.

While it can be seen that unhealthy social, political, and economic effects can flow from the overuse of junk bonds, there is a critical factor today that may be overlooked. In the past, junk bonds were almost all held by banks. Banks are best equipped to invest in these instruments because they have the ability, after all, to be understanding if the bond-floating firm faces new hurdles. Since junk bonds have historically been held by banks, it has always been possible to alleviate some of their bad economic effects.

Now, however, junk bonds are found in every nook and cranny of the investment market. Not only banks, but thrift institutions (who buy many of them), insurance companies, investment funds, and brokerage houses are among the purchasers, and many individual investors are attracted to their high yields as well. This array of institutions and individuals cannot provide the same debt management advantages and help that the banks can. They can hardly be understanding about new problems or unanticipated developments faced by the debtor firm. The junk-bondholders of today, then, are brittle rather than flexible, rigid rather than liquid. If a junk-bond-floating company runs into trouble, there is a good chance that it will go under.

The implications are broad indeed. The next crash, in fact, could be a “junk-bonds crash,” and this possibility is recognized even by many of the brokers who underwrite such instruments.

These concerns were unquestionably behind the recent proposal of Federal Reserve Board Chairman Paul Volcker to establish margin requirements on the floating of junk bonds. Until January 1986, it was possible to issue junk bonds on the strength of only 10 percent of their capital value. Volcker proposed that all junk bonds be issued with a margin requirement of 50 percent. The Reagan administration strongly objected, although its reasons were never very clear, for the most part befogged in platitudes about free enterprise. During the period of one month (early December 1985 to early January 1986) in which the Federal Reserve Board took opinions on the proposed rule, a compromise was worked out: a 50 percent margin is required in the event of a hostile take-over attempt; only 10 percent is necessary, however, in order to float these dubious instruments for the sake of friendly mergers or acquisitions or leveraged buy-outs of most kinds. Since hostile takeovers represented fewer than 20 of the 2,500 mergers of 1985 , this compromise was clearly an administration victory.

Now and the future

There are some weak arguments presented from time to time in favor of all of this churning and empire-building. T. Boone Pickens and other take-over artists say that they can engage in their activities because their targets have stock that is priced too low, and that this low price reflects mismanagement. A *Business Week* article recently stated that, although we do not see the benefits at the present time, the wave of mergers, acquisitions, and take-overs will yield great—but unspecified—benefits to all of us.

In my view, apologists for this phenomenon are caught in any number of dilemmas when they accept the manic drive behind these power trips of managers and directors, brokers and financiers, proxy fighters and take-over specialists as the exercise of free enterprise. If making their argument to Adam Smith, they would have to do an overarching amount of backing and filling to show how new conditions, or the anomalies of corporate structure, or the record of government intervention—or perhaps our astrological bearings!—have altered our classic understanding of the meaning of market competition.

All kinds of policy prescriptions suggest themselves as recent corporate history is surveyed. Simply removing the tax incentives, such as deductions for interest on debt for merger–acquisition–take-over activity would be a good start. Volcker's original margin requirement for junk bonds—50 percent for all of them, not just those used for hostile take-overs—is a worthwhile proposal. Better disclosure rules in corporate governance and especially in merger–acquisition–take-over activity would help to alert the public, stockholders, and various affected parties. The use of junk bonds should probably be restricted in various ways. Greenmail should probably be against the law, and both civil and criminal sanctions should be enacted. A much clearer statement of the real intentions of investors can be mandated. The stock exchanges should guarantee that firms they list treat all stockholders equally.

A great deal could be accomplished without enacting any new laws or regulations. The re-establishment of regulation, the renewal of antitrust enforcement, and a vigorous policy of requiring adherence to the law could all do a great deal to bring about a measure of social and financial (if not

political) responsibility to the corporate world. The tools are already there on the law books. This is not to say that the enforcement, or even the laws themselves, were adequate prior to the gross laxity of recent years; but it would be healthy for the American polity to return to a rule of law in matters of corporate organization and restructuring.